No. 15040

IN THE

UNITED STATES COURT OF APPEALS

For the Ninth Circuit

D. M. HAGGARD AND NILA HAGGARD,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF FOR PETITIONERS

On Petition for Review of the Decision of The Tax Court of the United States

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SUBJECT INDEX

TABLE OF AUTHORITIES CITED

Cases

Statutes

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OPINION BELOW

The only previous opinion is that of the Tax Court of the United States promulgated September 28, 1955. The findings of fact and opinion of the Tax Court (R. 11-24) are reported at 24 T.C. ....., No. 125.

JURISDICTION

This appeal involves income taxes. By a notice of deficiency, dated July 24, 1953, addressed to Mr. D. M. Haggard and Mrs. Nila Haggard, the Commissioner of Internal Revenue determined a deficiency of $3,480.96 for the taxable year of 1949 (R. 7). A petition was filed with the Tax Court of the United States on September 14, 1953, under the authority of Section 272 (a) of the Internal Revenue Code of 1939, for a redetermination of the deficiency set forth in the notice of deficiency (R. 5). The decision of the Tax Court was entered on November 9, 1955 (R. 25). Said decision found that there was a deficiency in income tax in the amount of $3,480.96. A petition for review by this Court was filed by the taxpayers on December 28, 1955 (R. 26). The jurisdiction of this Court to review the aforesaid decision of the Tax Court is founded on Sections 7482 and 7483 of the Internal Revenue Code of 1954.

STATEMENT OF THE CASE AND QUESTIONS PRESENTED

In November of 1945 John Butler and his wife, Hester, purchased 160 acres of farm land in Laveen, Arizona from Clyde Ewalt for $40,000 (R. 15). The terms of purchase required annual principal payments of $5,000 plus interest (R. 97, 98). During 1946 the 160 acres was farmed by the Butlers, and a profit of $4,000 to $4,800 was earned (R. 15, 85). In 1947, the 160 acres was rented for $4,000, and a profit of $3,844 was earned for that year (R. 15). Thus, at the end of two years of ownership, Mr. Butler had made a total profit of from $7,844 to $8,644, but had been required to pay the mortgagee two annual principal payments of $5,000 plus interest or a total of $10,000 plus interest (R. 15, 16). In short, the farm was not paying for itself from income, and the Butlers were forced to draw on their own reserves to make up the annual deficiencies between earnings and the amount needed for annual mortgage and interest payments. The balance owed to the mortgagee on the 160 acres at the end of 1947 was $22,000 (R. 100). In addition $6,500

was owed to the National Farm Loan Association (R. 91). Thus, a total of $28,500 remained due after the two annual payments of $5,000 each had been made for 1946 and 1947 (R. 91, 100). Adding the $28,500 still owing on the 160 acres at the end of 1947 to the total of $10,000 paid in 1946 and 1947 gives a total sum of $38,500. Therefore, the down payment made by Mr. Butler when he purchased the 160 acres for $40,000 in 1945 could not have exceeded $1,500 despite his testimony that he did not remember what he paid down, but thought it was $10,000 (R. 97).

At the end of 1947, Mr. Butler found himself in the following situation: He still owed $28,500 on the 160 acres; the 160 acres did not earn enough annual profit to pay the $5,000 yearly principal payments due Mr. Ewalt; he had been subjected to heart trouble in 1947 (R. 79, 80); Mr. Ewalt wanted the balance of the purchase price due him as quickly as possible so that he could build an apartment house in San Francisco (R. 16, 98); and his friends (a banker and head of a co-op) were urging him to pay his debts while times were good (R. 98).

It was in this context that Mr. Butler listed the 160 acres for sale with a real estate broker in the latter part of 1947 or early days of 1948 (R. 16). The price asked was $48,000 (R. 16). Subsequently, at least six prospects responded to the listing (R. 16, 87). However, no sales were consumated because these individuals were interested in trading other property for the 160 acres rather than buying for cash (R. 87). For example, one man wanted to trade in a first mortgage on an apartment house, and another wished to trade in 20 acres, while a third offered a Ford (R. 87)! Finally a man named Talby offered to buy the property for $8,000 down and the balance in ten equal payments (R. 16, 88).

Nevertheless, Mr. Butler did not accept the offer of Mr. Talby or agree to sell because he wanted to get his money "just as quick" as he could (R. 16, 98, 99). Instead he contacted the

petitioner, D. M. Haggard, whose land adjoined Mr. Butler's on two sides, to determine if Mr. Haggard was interested in the 160 acres (R. 16, 88). Petitioner, D. M. Haggard, told Mr. Butler that he was willing to lease the 160 acres for $10,000 in 1948 and $12,000 in 1949, and pay $2,000 for an option permitting him to elect to buy the acreage in 1950 for $24,000 (R. 41). Neither the $2,000 option payment nor the lease payments of $10,000 and $12,000 were to apply against or act as a credit on the purchase price of $24,000 to be paid in 1950 if the option was exercised (Exhibits 1, 2; R. 13). Thereafter, Mr. Butler and Mr. Haggard went to the office of Mr. Haggard's lawyer, J. D. Merrill (R. 42, 75), who prepared the Lease and Option agreements (Exhibits 1, 2) which were executed by Mr. Butler after he agreed to the transaction (R. 96).

About one week after signing the Lease and the Option in Mr. Merrill's office, Mr. Butler took the papers to his own lawyer to see "if it was bona fide," and was advised that "it was all right" (R. 77). Prior to and at the time Mr. Butler consulted his own lawyer about the Lease and Option transactions, his income tax returns had been prepared by a lady who maintained his books and records. Later this individual moved, and in January of 1949 Mr. Butler retained a firm of certified public accountants in Phoenix, Arizona, to prepare his 1948 federal income tax return (R. 77). It was this firm which advised Mr. Butler to report the 1948 transaction as a sale rather than a lease (R. 78). In other words, as Mr. Butler testified: "The tax men fixed it up" (R. 83). Consequently, on Mr. Butler's federal income tax return for 1948, the Haggard rental payment of $10,000 was not treated as ordinary income (R. 83, 84). Instead the transaction was reported as the sale of a capital asset held for more than six months (R. 83, 84). The gain was computed by adding the cost of a well ($2,200) to the original cost of the land ($40,000) for a total adjusted cost basis of $42,200 which was then subtracted from $48,000 ($2,000 option payment plus $10,000 and $12,000 of lease payments plus $24,000 purchase price) (R. 83,

84). One-half of the resultant "gain" of $5,780 or $2,890 was reported as income received in 1948 (R. 83, 84). In this way, Mr. Butler avoided paying ordinary income tax on $10,000 of lease payment for 1948 and $12,000 of lease payment to be received in 1949.

On the other hand, petitioners deducted the $12,000 paid to Mr. Butler during 1948 pursuant to the least agreement under the authority of Section 23 (a) (1) (A) of the 1939 Internal Revenue Code. The Commissioner of Internal Revenue disallowed the $12,000 deduction "on the ground that the payment was not rental expense within the meaning of Section 23 (a) (1) (A) of the Internal Revenue Code of 1939" (R. 18). In explaining more specifically the basis of the disallowance, respondent stated at the trial below that:

> " . . . The respondent's position is that substance and not mere form should be looked to in order to determine whether there was actually a lease and option or whether the entire transaction comprehended a purchase and sale of the premises *on February 9, 1948.*
>
> The evidence will show that there was an intent on the part of the parties to this transaction to make a sale and to make a purchase. The so-called rental payments made under this contract, this transaction, would, therefore, actually constitute the purchase price of a capital asset and not the payment in the nature of rent within the meaning of Section 23 (a) of the Code . . ." (R. 37, 38). (Emphasis supplied)

The Tax Court, in its opinion, agreed that the above "substance versus form" statement set forth the only question for decision by saying that:

> " . . . The *sole issue* to be decided is whether the so-called 'rental' payment was in fact a payment or rent under the lease and deductible as such, or a partial payment of the purchase price of the property." (R. 18). (Emphasis supplied)

In deciding that sole issue, the Tax Court ruled as follows:

> "The most recent consideration of this issue was in Bruce

Veneer & Panel Co., 22 T.C. 1386 (1954) (on appeal C.A.7). There, petitioner entered into a 'Lease' and 'Option to Purchase' agreement with the R.F.C. with respect to certain property, in part of which it was at the time conducting its business. Under the agreement, petitioner was to pay 'as rent' $100,000 in 60 monthly installments, after which it had the option to purchase the property for $50,000. The Court held, despite the explicit language of the lease agreement, that since the rental payments materially exceeded the *current fair rental value* of the property, and since the aggregate payments paid prior to the exercise of the option were disproportionate to the relatively small final amount required to obtain title, *petitioner was building up a substantial equity* interest in the property, *as intended by the parties,* and that the payments, *in reality,* were being applied to the agreed purchase price of the property. We are of the opinion that the rationale there expressed is applicable here. Judson Mills, supra; Robert A. Taft, 27 B.T.A. 808, 812 (1933); Holeproof Hosiery Co., 11 B.T.A. 547 (1928)" (R. 19, 20). (Emphasis supplied)

It is the above analysis of the law which gives birth to each of petitioners' assignments of error, and the question presented to this Court.

The question is whether the Tax Court correctly interpreted Section 23 (a) (1) (A) when it held that if rental payments exceed fair rental value of the property and the total of such payments are disproportionate to the final payment required to obtain title, the parties *intended* to and did acquire an equity in the property, and that such rental payments were in reality payments on an agreed purchase price?

SPECIFICATION OF ERRORS RELIED ON

(1) The Tax Court erred in determining that the sole issue was whether the $12,000.00 payment was in fact a payment of rent.

(2) The Tax Court erred in holding that where a "lessee" acquires "something of value" in relation to the overall transaction, the "rental" payment does not come within the definition

of rent in Section 23 (a) (1) (A) of the Internal Revenue Code of 1939.

(3) The Tax Court erred in relying on *Breece Veneer & Panel Co.,* 1954, 22 T.C. 1386 (on appeal C.A. 7th).

(4) The Tax Court erred in holding that when rental payments materially exceed the current "fair rental value" of the property "leased" and where the total payments made prior to the exercise of the option are disproportionate to the relatively small final amount required to acquire title, the "lessee" is building up a substantial equity interest in the property, as intended by the parties, and the payments in reality are being applied on the agreed purchase price of the property.

(5) The Tax Court erred in finding that the intention of Mr. Butler and petitioners was to effectuate a sale on February 9, 1948.

(6) The Tax Court erred in finding that the value of the 160 acres on February 9, 1948, was not $21,750.00.

(7) The Tax Court erred in finding that the fair rental value of the 160 acres did not exceed $5,000 for 1948 and 1949.

(8) The Tax Court erred in its holding that petitioners did not carry their burden of proof with respect to the fair market value of the 160 acres on February 9, 1948.

(9) The Tax Court erred in treating as evidence the legal presumption of correctness attaching to the Commissioner's determination.

(10) The Tax Court erred in that its decision is not supported by the evidence, is clearly erroneous, and is not in accordance with law.

ARGUMENT

There are two good reasons why the Tax Court should be reversed in this case. They are *Breece Veneer & Panel Co.,* 7 Cir.,

decided April 26, 1956 (56-1 USTC ¶ 9485 and *Benton* v. *Commissioner,* 5 Cir., 1952, 197 F. 2d 745.

Each of the above cases interpreted the identical portion of Section 23 (a)(1)(A) of the 1939 Internal Revenue Code involved herein which provides that a taxpayer may deduct from gross income:

> " . . . rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

Therefore, it is important to determine why the *Breece* case, *supra,* and the *Benton* case, *supra,* call for the reversal of the Tax Court's decision in the appeal before this Court.

In ruling that petitioners' payment of $12,000 during 1949 under the Lease agreement was not allowable as a deduction under the above language of Section 23 (a)(1)(A), the Tax Court rested its decision on the rationale expressed in *Breece Veneer & Panel Co.,* 1954, 22 T.C. 1386. After setting forth its rule, announced in the *Breece* case, *supra,* the Tax Court decided against these petitioners saying:

> " . . . We are of the opinion that the rationale there expressed is applicable here."

However, the Tax Court's decision in *Breece Veneer & Panel Co.,* 1954, 22 T.C. 1386, was reversed by the U.S. Court of Appeals for the Seventh Circuit on April 26, 1956.

The opinion of the Seventh Circuit in that case, citing *Helvering* v. *San Joaquin Fruit and Investment Co.,* 1936, 297 U.S. 496, 56 S.Ct. 569, held that there was no equity until the option was exercised. Applying that view to the facts of this case, it is clear that the $12,000 lease payment made during 1949 was a proper deduction under Section 23 (a)(1)(A) because the petitioners did not exercise the option involved in this case until January of 1950.

Furthermore, not only did the Tax Court err in resting its

decision on its earlier opinion in *Breece Veneer & Panel Co.,* 1954, 22 T.C. 1386, which was later reversed in 7 Cir., decided April 26, 1956 (56-1 USTC ¶9485) but its decision in this case also contravened *Benton* v. *Commissioner,* 5 Cir., 1952, 197 F. 2d 745.

When the Tax Court applied the above quoted language of Section 23(a)(1)(A) to the facts of this case, its opinion concluded that the "*sole issue* to be decided is whether the so-called 'rental' payment was in fact a payment of rent under the lease and deductible as such, or a partial payment of the purchase price of the property." In other words, the Tax Court viewed the problem, as did respondent, simply as a matter of looking to "substance and not mere form" to determine if there was a sale of the premises on February 9, 1948. On this issue, which the Tax Court itself said was the sole issue, petitioners should prevail.

This same problem was before the U. S. Court of Appeals for the Fifth Circuit in *Benton v. Commissioner,* 5 Cir., 1952, 197 F. 2d 745, 752, wherein the Court said that the question is whether "what was in form a lease was in substance and according to the real intention of the parties a conditional sale contract." U. S. Circuit Judge Rives, writing for the Court, held at page 752 that:

> "*If the parties* in good faith actually *intended* to enter into *a lease* contract, then the taxpayer, up until the time that he exercised his option to purchase, acquired no title to or equity in the property." (Emphasis supplied)

In emphasizing that it was the intention of the parties that controlled, Judge Rives stated that for the Tax Court to decide by application of an objective economic test that a taxpayer had an equity in the property effectively begs the question to be decided, namely whether the parties intended a lease or a conditional sale contract.

But this is not the rule applied by the Tax Court in this case. Instead it held that:

"The most recent consideration of this issue was in Bruce

> Veneer & Panel Co., 22 T.C. 1386 (1954) (on appeal C. A. 7) . . . The Court held, despite the explicit language of the lease agreement, that since the 'rental' payments materially exceeded the current *fair rental value* of the property, and since the aggregate payments paid prior to exercise of the option were disproportionate to the relatively small final amount required to acquire title, petitioner was building up a substantial equity interest in the property, *as intended by the parties,* and that the payments, in reality, were being applied to the agreed purchase price of the property. We are of the opinion that the rationale there expressed is applicable here." (R. 19, 20). (Emphasis supplied)

Petitioners ask the Court to notice that the Tax Court's rule in this case has again determined the intent of the parties by applying an objective economic test. It says that if the payments materially exceed a current *fair rental value* and the total payments paid before the option is exercised were disproportionate to the relatively *small final amount* paid to acquire title, petitioner is obtaining an equity interest *as intended by the parties* and the payments are in reality applied to an agreed purchase price. Under this view, the intent of the parties depends on fair rental value and the size of a payment made to acquire title. In short, the Tax Court finds that the parties intended a conditional sale if these two economic tests are met. Thus, the intention of the parties is merely supplemental to economic "facts" alone.

Such an approach by the Tax Court contravenes both the substance and the spirit of the rule of *Benton v. Commissioner, supra.* As the Court said on page 752 "there being here involved no restraint by law or public policy, the parties had full liberty to contract as they pleased" citing as authority *Hervey v. R. I. Locomotive Works,* 1877, 93 U.S. 664, 672, 23 L. Ed. 1003; *Helvering v. Lazarus & Co.,* 1939, 308 U.S. 252, 255, 60 St. Ct. 209, 84 L. Ed. 226; *Bankers Mortgage Co. v. Commissioner,* 5 Cir., 1944, 141 F. 2d 357; *Hogan v. Commissioner,* 5 Cir., 1944, 141 F. 2d 92, 93; *West v. Commissioner,* 5 Cir., 1945, 150 F. 2d 723.

Consequently, the situation before this Court is the same as that presented to the U.S. Court of Appeals for the Fifth Circuit in *Benton v. Commissioner, supra.* Just as the Fifth Circuit stated in that case, the inference or conclusion that the parties intended a sale on February 9, 1948, is naturally weakened when it is based upon objective economic tests, and is merely supplemental to economic facts alone. Thus, the Court of Appeals there held that it should review the inferences and conclusions as to the intention of the parties, correctly pointing out that the errors complained of were concerned with the inferences and conclusions which it could review. When taking such a step, the following factors are offered for this Court's consideration.

The very best evidence of a man's intention are the written documents to which he signs his name under oath. Many reasons arise why laymen taxpayers subsequently conclude that they did not "intend" the legal conclusion which resulted from documents executed by them after consultation with an attorney. For instance, Mr. Butler signed a document clearly designated a Lease in which he agreed to let the subject 160 acres to petitioners, and acknowledged before a notary public that he executed the Lease for the purposes therein stated (Exhibit 2). One week later he took the Lease to a lawyer of his own choosing to see if it was "bona fide," and was advised that it was all right. However, when the time came to file a Federal income tax return for 1948, a firm of certified public accountants advised him to report the transaction as a sale, and he reported only one-half of the gain (R. 17, 83, 84) or $2,890. Subsequently Mr. Butler "wrangled" with a U.S. Internal Revenue Agent, and told his bookkeeper to treat the payment as rent and pay the additional tax (R. 78). Furthermore, in April of 1949, nearly fourteen months after Mr. Butler "sold" the 160 acres, he mortgaged the land for $12,000 after obtaining a subordination agreement from petitioners in which they agreed that their option would be subordinate to a mortgage on the property (R. 17). In explaining the initial transaction to the trial judge in 1955, Mr. Butler testified that while he did

not know who suggested it or why the instruments were drawn in the form of a Lease and an Option, he did agree "to it at that time that way" (R. 96).

The above factors certainly indicate an individual who knew that he was leasing 160 acres of farm land on February 9, 1948, and was granting the lessee a separate option to purchase for a purchase price of $24,000. Nevertheless, the Tax Court's opinion mentions other considerations which it is said support a conclusion that there was an intention by Mr. Butler that he was selling the property on that date. First, the Tax Court found that Mr. Butler had, at the time of the transaction with petitioners, an offer of "purchase" from the Talby group of $48,000. However, Mr. Butler refused this offer because the purchase price was to be paid $8,000 down and the balance in ten equal installments, and he wanted to get the money out as quick as he could (R. 98, 99). Therefore, when he entered into a Lease and an Option with petitioners, Mr. Butler deliberately and consciously chose to lease for two years for $22,000 and grant an option to buy for $24,000. If he had intended a "sale," all Mr. Butler had to do was go ahead and "sell" to the Talby group. In this regard the Tax Court notes that Mr. Butler would not have considered making an outright sale for $24,000 on February 9, 1948. The fact is that he was quite anxious to do so as long as the 160 acres could be leased for two years for $22,000 before the 160 acres was sold. Again it is economics that are being relied upon to determine if the "parties in good faith actually intended to enter into a lease contract." *Benton v. Commissioner, supra.* Possibly Mr. Butler would not have agreed to sell the 160 acres on February 9, 1948, but how does that bear on the question of whether he actually intended to lease the property for two years for $22,000 on February 9, 1948, *and* subsequently sell for $24,000 to petitioners? One who buys a horse for $40 may not sell Dobbin for $24, but at the same time be quite willing to lease the horse for two years for $22 and then sell for $24.

In reaching its decision in this matter, petitioners wish to emphasize to the Court the thought expressed in *Benton v. Commissioner, supra,* at 753, by U.S. Circuit Judge Rives who said:

> "Within the limits of reason, the parties had a right to exercise their own judgment, and that of the Commissioner or of the Tax Court cannot be substituted therefor."

CONCLUSION

The decision of the Tax Court in the instant case is erroneous and should be reversed.

Dated: Phoenix, Arizona
June 1, 1956

Respectfully submitted,

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